September 2015

Late in 2006, Matthews Asia was wrapping up a special report titled “Japan Reawakens.” The timing of that AsiaNow publication, just ahead of the Global Financial Crisis, was unfortunate to say the least. With the ensuing economic turmoil, Japan fell asleep again, sliding off the radar screens of many investors. But as interest in Japan has more recently re-emerged, I thought it would be important for us to take a look back and consider what we previously published. Has Japan evolved the way we had envisioned? What’s changed and what hasn’t? And most importantly, where do we go from here?

Governance at Japan Inc.

A major theme in that issue of AsiaNow was “Restructuring of Japan Inc.” We discussed topics such as shareholder-friendly governance, the shakeup of cross shareholdings, using catchy phrases like “this is not your father’s Japan” and “from stakeholders to shareholders.” We spoke too soon. Japan’s corporate governance made little improvement in the years that followed. The Global Financial Crisis ushered many companies back into their cocoons, where they found comfort in cash-hoarding practices that shielded them during tough times. I recall a steel company executive telling me, “We survived because we had this cash, why should we pay it out?” Only recently, have the tides begun to shift again.

Japan’s Stewardship Code of 2014 and its Corporate Governance Code in 2015 are measures that reflect the strong determination of Prime Minister Shinzo Abe’s administration to bring Japan’s corporate governance practices further in line with global practices. In reality, the code itself still falls short of global best practices, and needs continued improvements. For instance, it does not mandate a majority independent board, there are few repercussions for non-compliance and it lacks a regular monitor-and-review process.

Still, we’ve observed a noticeable change in how corporate managers interact with investors and the market in general—some more than others. That changing mindset is evidenced by the increase in shareholder returns in the form of both dividends and share buybacks. On the back of strong earnings, dividend payouts for firms on the Tokyo Stock Exchange’s 1st section have reached a historical high. Note that the figures in the chart below reflect only dividends and buybacks that have already been executed. There are even more buybacks announced but yet to be executed.
However, improving corporate governance isn’t simply about paying out excess cash. Ultimately, Japanese corporate managers need to become better stewards of capital. That means improving capital returns by unwinding unproductive cross shareholdings and investing for growth. Already, several major financial institutions have announced plans to comprehensively review their cross shareholdings. Japanese firms have also been active in cross border acquisitions with more than US$50 billion spent year-to-date as they invest for growth.

These developments give me some hope that progress will be made over the next several years. Remember, change in Japan rarely happens quickly. There may even be times when it looks like it’s taking a step back. Hence, it’s important for investors to temper expectations, have some patience and let the evolution play out.

The Evolving Relationship with Asia

Another major theme from the AsiaNow newsletter, published in 2007, was Japan’s integration with Asia. Back then, the relationship was more about offshoring production to China and other Asian nations, but the end market for such products were still consumers in developed economies. Japanese companies needed cheap labor, China needed employment. And this resulted in a rapid expansion of trade between Japan and its neighboring countries.
While Japan’s integration with Asia has continued, the relationship has evolved over the years. Japanese companies no longer view Asia as merely a source of cheap labor. In fact, manufacturing costs have risen substantially in China due to continued wage growth. While the localization of production to China, and in some cases from China to Southeast Asia, has continued, the primary motive now is to serve the burgeoning middle class in those local markets rather than to export products to developed markets.

In particular, Japan is home to established and well-managed consumer brands, which are lacking in the rest of Asia. Japanese brands are typically associated with quality while its product positioning is often in the affordable segment (in contrast to European/U.S. brands that dominate the luxury segment). Back in 2007, Japanese products were simply too expensive for Asia’s middle class, but as incomes have grown over the years, consumers have sought to trade up for better quality, creating a market for Japanese brands that did not previously exist.

I recall speaking with the CEO of a Japanese consumer product company in 2009 about his firm’s China strategy. He mentioned “When we started in China in 2002, I think only 10% of the population could afford our product. By 2007, that came up to 15% and now it’s about 20%.” When I visited the same company last year, managers there said they were still in the development stage in China, and estimated that 30% of the population could afford their products. “And that alone is several times bigger than our domestic market,” they noted. Asia’s emerging middle class presents an enormous opportunity for Japan’s consumer brands.

![ASIA HOUSEHOLD INCOME](image)

**ASIA HOUSEHOLD INCOME**

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Local currency, 2007 = 100, nominal figures
Source: CEIC
¹ China is urban household income
² Indonesia is income for manufacturing workers
Automation

In 2007, Chinese manufacturers were not interested in automation as labor was abundant and cheap, and the payback period for the capital investment in a robot was simply too long. That has changed drastically in recent years. As wages across Asia continue to rise, businesses have been forced to adopt more technology into their processes to drive productivity and protect profit margins. Additionally, labor shortages are now a reality in China’s manufacturing sector as the younger generation of workers simply prefers not to work in a factory. Robotics and other modes of automation are increasingly being utilized to counter the impact of increasingly expensive and scarce labor. As a result, exports of Japanese capital goods have increased rapidly. And an often overlooked benefit of automation is higher quality. The ability to consistently produce at a higher quality provides the fundamental basis for these businesses to climb the value chain.

This automation trend is likely to continue over the long term as part of Asia’s evolution. However, it’s important to keep in mind that capital goods have always been, and will continue to be, cyclical businesses that are driven both up and down by investment cycles. Currently, slowing automobile sales in China are leading to an oversupply condition in its automotive industry, which has been a large consumer of Japanese capital goods. With manufacturers curtailing production, additional capital investment is unlikely in the short term.

Finding Opportunities in Japan’s Labor Shortage

A key motivation for Japanese companies to shift production overseas has been Japan’s aging and declining population. In the aforementioned issue of AsiaNow, we talked about Japan’s looming labor shortage, which is now becoming a more pronounced reality.

With improving economic conditions, the re-shoring of production and the impending retirement of the baby boomer generation, labor shortages also loom. Companies are now aggressively hiring new college graduates with almost 97% of new university graduates having secured jobs this year. Youth unemployment in Japan has fallen to a mere 5.5%, much lower than the U.S. at almost 12% and the E.U. at about 21%. Female labor participation is rising as well. However, given the imbalance in the number of workers retiring compared to those entering the labor force, simply hiring new graduates and women will not be enough to make up the difference.

Labor shortages are leading to gradually higher wages for workers in industries such as retail, construction, transportation, restaurants and hospitality where demand outstrips supply. Many businesses in these industries struggle to pass on the cost of higher wages to customers. Hence, they are experiencing pressure on margins. These are also the industries in which productivity is low. In fact, productivity levels for Japan’s non-manufacturing sector remain significantly lower than the U.S.

To counter the impact of higher costs, service sector companies are increasingly adopting technological innovation. Recently, Japan saw the opening of a hotel operated primarily by robots, from check-in to luggage handling. Instead of room keys, the hotel uses face recognition technology. We see more retailers adopting automated ordering systems to lighten the burden on store-level operations. A startup recently started experimenting with self-driving taxis, with the aim deploying them before the 2020 Olympics.
In an adverse economic environment, the risk remains that Japanese corporate managers will take some backward steps, failing to meet higher market expectations for governance improvements. However, slow as it may be, Japan’s evolution has chugged along the general path we envisioned in 2007. The fundamental building blocks for corporate governance improvements are solidly in place. Any steps backward will likely be temporary. Structural changes to improve productivity should support future growth prospects. Despite any of its short-term challenges, we still firmly believe in Asia’s growth. And that presents significant opportunities for Japan Inc.

Kenichi Amaki
Portfolio Manager
Matthews Asia

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